CHAPTER 2
THE ASIAN CONTEXT: FINANCIAL TURMOIL

Introduction. Not to be outdone by financial turmoil in Europe and Latin America in the 1990s, Southeast Asia took center stage in 1997. But who would have predicted it? As we look back at the Asian economic crisis, the words from Charles Dickens' *A Tale of Two Cities* come to mind, "It was the best of times, it was the worst of times." While the words once described France on the eve of the French Revolution, these same words could just as easily be used in 1997 to describe the rise and fall of the economies in Southeast Asia.

Just a few years before, the World Bank singled out the economies of the Asian tigers as models for long term economic development. The World Bank published a book entitled *The East Asian Economic Miracle*.[1] It seemed like "the best of times."

Financial Nightmare. Unfortunately, 1997 was a nightmare for the region. In July of 1997 currency traders savagely attacked the Thai baht. Before long, the currency crisis spread across Southeast Asia. After forcing an 18% devaluation of the Thai baht on 2 July, currency speculators quickly turned on other neighboring countries linked to the U.S. dollar. Before long, Indonesia, once the darling of the IMF and World Bank, had to approach these Bretton Woods twins for an embarrassing rescue package of its own. By December 1997, South Korea was on the verge of national bankruptcy. They faced a foreign exchange crisis, stock market meltdown and a bank panic. Like Thailand and Indonesia, South Korea had to go to the IMF at the 11th hour to fend off financial disaster.

During the first half of 1998, the crisis-hit Asian countries went into a deep recession. Indonesia went into a depression with about 15% unemployment. But the worst was yet to come for the global economy.

Setting the Stage

Stable Currency Mindset. During the best of times, most of the Asian tigers believed that a rock-steady currency was the fundamental foundation for their economic success. For over a decade they generally held their currencies stable against a basket of currencies dominated by the U.S. dollar. Currency stability inspired confidence among traders and foreign investors. Economic relations with them consequently appeared to be relatively risk free. For much of the decade running from 1985 to 1995, Japanese manufacturers, in particular, saw Southeast Asia as an attractive production refuge from a strong yen. Southeast Asian currencies virtually pegged to a weak U.S. dollar gave tiger exports a competitive shot in the arm.

Capital Inflow. In the boom years of 1994 and 1995, weak currencies attracted huge capital inflows. Much of it was Japanese money. But despite these capital inflows, tiger governments, anxious to maintain price advantages for its exports, generally resisted pressure for their currencies to appreciate against the dollar. The result was an unhealthy surge of domestic liquidity. The combination of high national savings and large capital inflows produced huge pools of financial capital, which tiger businessmen used to drive the economic growth. Add cheap labor to the mix and it's little wonder that this economic formula helped the manufacturing exports of the Asian tigers grow by leaps and bounds.

Over-Valued Currencies. The flip side of weak tiger currencies (which were making their exports so attractive) was a strong yen that was undermining the export competitiveness of Japan. In November of 1994, U.S. Treasury Secretary Robert Rubin replaced Lloyd Bentsen's weak dollar policy with a strong dollar policy. After the dollar hit a rock bottom 79.70 yen to the dollar rate on 18 April 1995, the G3 (the United States, Germany and Japan) collaborated and pushed the dollar up 40% against the yen between 1995 and 1996.[2] Since tiger currencies were generally pegged in a de facto sense to this rising U.S. dollar, the price of tiger exports became less competitive in 1996 and 1997.

PRC Devaluation. Meanwhile, in January of 1994 China devaluated its currency (the yuan)

50% against the U.S. dollar. That gave China the potential to radically under-price the manufactured goods of the Asian tigers. This new export price advantage (plus the new export capacity China was bringing on stream) hurt tiger exports in 1996.

Collapsing Exports. As a result, almost all of the Southeast Asian exports began to stumble in 1996.[3]

- For instance, the contrast between Thailand's merchandise export growth in 1995 (25%) and Thai export growth in 1996 (0%) was startling.
- This zero Thai export growth in 1996 pushed the Thai current account—which measures trade in goods and services—into a huge deficit of 8% of GDP.

Currency Vulnerability. Given these trade difficulties, Wall Street and other financial capitals perceived the currencies of the Asian tigers as overvalued. And the more overvalued a currency, the greater the perception that this situation is unsustainable and the greater the incentive for speculators to attack it.

Relaxed About Trade Deficits. Why weren't the tigers more concerned about the high current account deficits? Their leaders conceded that large current account deficits could be a bad thing. But they made the logical economic argument that if a current account deficit mostly reflects higher investment, it will eventually increase an economy's competitiveness, and therefore its ability to repay the debt, and will certainly be more sustainable than a deficit driven by consumer spending.

"We're not Mexico." Tiger leaders were also quick to contrast their investment oriented current account deficit with Mexico's consumption driven current account deficit. In the four years prior to 1994, four-fifths of the increase in Mexico's current-account deficit reflected lower savings and increased consumption. In contrast, the widening deficits of most of these Asian economies reflected higher investment, not consumption.

On the surface, all of this made perfectly good sense. But the underlying assumption here was that most of this "investment" spending was intelligent and potentially profitable. Unfortunately, nothing could be further from the truth. As our story unfolds, we will see that much of the so-called investment was foolishly spent on an oversupply of property development and redundant manufacturing capacity rather than improving the quality and competitiveness of tiger exports. [4]

Wishful Thinking. In addition, tiger leaders generally dismissed the zero export growth as primarily "cyclical," reflecting potentially reversible factors such as the weak demand in Japan and Europe and the rising U.S. dollar. They hoped that both factors would somehow turn around in 1997. Such wishful thinking was no substitute for a coherent strategy and would come back to haunt them in the months ahead.

Rigid Model. Meanwhile, the rigid economic model of the tigers made it increasingly difficult for them to adjust to the new realities of a rising current account deficit.

- If the tigers had been in a floating exchange rate system, the large current account deficit would have caused the baht to gradually depreciate.
- A weaker currency would have increased the demand for their exports and decreased consumption of imports.
- That in turn would have lowered the current account deficit and made it possible for them to balance their payments without the need for huge (and potentially destabilizing) capital inflows.

But even when the financial crisis became impossible to miss, tiger governments still had a rigid mindset about stable currencies being the centerpiece of their economic success in the previous ten year period. Conditioned by years of rote learning and bound in their mental straightjackets, it was impossible for tiger leaders to imagine economic success in a floating exchange rate system.

Thai Nightmare. The tiger fixation with stable currencies was particularly true in Thailand. In a country with more than its share of political and economic turmoil, the currency peg seemed to many as the only stable thing

left in Thailand.[5] Consequently, the Thai government refused to let the baht adjust to a 40% rise in the dollar against the yen from 1995 to 1996, despite a rising current account deficit. Given the Thai determination to keep the baht stable, a way had to be found to prop it up and counter the downward pressure on the baht from the large current account deficit. Bangkok's fatal "solution" was to raise domestic interest rates to punishingly high levels. These high interest rates hammered the economy in a number of ways.

Thai Carry Trade. For starters, the high interest rates encouraged a Thai carry trade known as the "Thai baht basket trade." This financial gig consisted of borrowing in dollars, marks or yen to finance investments in Thai baht bonds or baht bank deposits.[6] Another causal factor was the role that the baht carry trade played in the buildup to the crisis. Massive baht positions had accumulated solely because of the presumption that the bank's peg for the currency would endure. In February 1997, the spread between Thai baht interest rates and the Bank of Thailand's basket (dollars, yen, and marks) ranged between 500 and 600 basis points. The Thai baht carry trade, in all of its variations, involved being long on the baht and short on dollars, yen and marks.

Worsens Property Glut. In addition, the high interest rates exacerbated problems in the property and banking sectors, clobbering property developers and making it virtually impossible for many to pay loans back to their banking creditors. At the same time these non-performing loans began to pile up inside the banks, high interest rates were also deflating the value of banking assets, thus crippling the solvency of the embattled financial sector. That caused corporate earnings and stock prices of Thai financial companies to plunge.

Over-priced Exports. High interest rates also hurt many manufacturers. It artificially strengthened the baht, which in turn made exports less competitive. The high interest rates also caused Thai consumers to be more spendthrift, which in turned shrunk aggregate demand at home. That caused the economy in 1997 to a grind to a virtual standstill. As the liquidity and asset problems of banks and corporations began to multiply, they turned to the Thai central bank for relief. Unfortunately, the central bank had to tell the business and banking communities that there simply was not enough money to go around.

Cheap Foreign Money. The punishingly high interest rates made it a non-starter for Thai businessmen to borrow money at home in baht. That prompted increasing numbers of Thai borrowers to go overseas for cheap capital. Thai financial firms assumed it was perfectly safe to take out foreign loans for their Thai business clients.

Capital Inflow. The result was a flood of cheap foreign money that allowed banks to make foreign currency loans in dollars at interest rates far lower than loans in baht. In the two-year period from 1995 to 1996, foreign borrowing by Thai financial firms almost doubled. By 1996 Thai companies and individuals had piled up huge dollar debts. In fact, by 1996 they owed more than $70B. That figure amounted to half the GDP of the country. Thus a gigantic stock of dollar-based indebtedness massed in Thailand in the years leading up to the crisis of 1997, putting the country in a very dangerous position. Effectively, the Thai government balance sheet was long their domestic currency and short dollars, all based on a wing and a prayer that their fixed exchange rate regimes would endure. This huge capital inflow covered the current account deficit in the Thai balance of payments. Problem solved? Not exactly. On the surface, all was well. But not all capital inflows are the same.

Hot Money. Had Thailand been receiving a lot of foreign direct investment, this relatively "permanent" money would have contributed to financial stability. Instead, Thailand was using a dangerously high percentage of short-term capital or "hot money" to cover its current account deficit. If financial stability had been a Thai goal, such hot money flows were certainly not a dependable way to get there.

Bad Debt. Consequently, the investment-rating agency Moody's downgraded Thailand's short-term debt rating. Moody correctly

argued that this over-reliance on volatile, footloose money made Thailand increasingly vulnerable to a Mexican-style financial shock. The IMF told Bangkok much the same thing. Bangkok stubbornly ignored their warnings.

Over-capacity. Before long, the Thai economy became addicted to cheap foreign currency. The huge capital inflows left Thai banks awash in cash. Thai banks asked themselves, "What should be done with all this money?" Thai banks turned around and lent too much of this huge pool of excessive liquidity to politically well-connected businessmen for hare-brained schemes. A huge property glut developed, which in turn triggered more and more bad loans.

Financial Crisis Arrives

Pressure started to build on the Bank of Thailand in December 1996 to devalue the baht. Revelations that several of the Thai finance companies were over-exposed to the foreign financed property glut triggered a speculative attack on the baht in early February 1997. By March Bangkok was facing the most serious financial crisis in Thai history. But the truly remarkable aspect of the Thai crisis was the poor response of the Bank of Thailand (BOT). The outcome for Thailand would have been much improved if the bank had simply ignored the crisis and done nothing more than letting the baht float.

In the first two weeks of May 1997, the BOT decided to switch its intervention to defend the baht from spot foreign exchange transactions to forward transactions, buying baht against dollars for value in three months. The BOT chose to ignore the implications for its balance sheet. The BOT was therefore massively exposing itself to the fate of its own currency. Speculators thereby effectively received a subsidy from the bank to take short positions in the baht. Thanks to the BOT, the baht then turned into a one-way bet for short sellers. It would have been practically impossible for the short sellers to accumulate such an enormous short position in the baht had it not been for the sales that the BOT made.[7]

Similar to Mexico. The exact parallel here is with the blunder made by the Central Bank of Mexico in issuing the dollar-linked tesobono bonds discussed earlier. Like the dollar-linked tesobonos, the Thai bank's forward contracts constituted a financial time bomb that the bank itself planted underneath the state treasury. Nothing can excuse the BOT having committed the financial blunder of the decade in supplying all comers with massively cheap financing on short baht positions.

Reserves Shrink. Despite optimism in Bangkok that things would get better, the economic data in no way supported such blind optimism. The grim facts included a slowdown in Thai exports and GDP growth, a sharp fall in the stock market and more and more bad loans.[8] The data showed that unexpectedly high imports had caused the current account deficit to balloon. With a shortfall of capital inflows, Bangkok had to use $4B of foreign reserves between the end of April and the end of May to cover a balance of payments deficit.

Baht Falls. On July 2, after spending billions of dollars trying in vain to maintain the baht at around Bt25 per dollar (where it had stood for more than a decade), Bangkok announced a managed float, thus abandoning the peg to the dollar. Unfortunately, Bangkok offered the markets no coherent economic strategy to accompany the so-called managed float. By early September, the baht went into a nose-dive, dropping to the Bt38 per dollar threshold for a fall of 32% against the dollar since July. In the next 6 months the baht dropped from 26 to the dollar to 55. Thailand circa 1997 indeed had turned into Mexico circa 1994. With no credible way to plug the hole in its balance of payments or to finance more rescue schemes, Bangkok was forced to look for outside assistance. In early August the Thai government accepted IMF conditions for a $17.2B financial package.

Lessons Learned

In this chapter and the previous one, we've looked back at global financial turmoil in the 1990s. The findings from this study will hopefully provide insight for shaping key U.S. decisions on a number of global economic and financial issues. We've studied those events—in Europe, Latin America and Asia—

where the sharpest reversals of financial fortunes took place. So what have we learned?

Macroeconomic Mistakes. First, large-scale and ill-advised macroeconomic policies of the major economies can and do have major impacts on regional and global financial order. In Europe, we saw where German Chancellor Kohl's worry free view of German unity was dead wrong. Based on this faulty assessment, the Kohl government badly mismanaged German unity. Bonn made one bad economic decision after another.

- The first mistake was the virtual one to one conversion rate between the eastern mark and the western mark.
- The second mistake was rising wage parity between east and west German workers.

Together, these mistakes caused the costs of German unity to soar. Karl Otto Pohl, President of the Bundesbank, correctly predicted "disaster" and resigned as a statesman in protest over Bonn's follies. Instead of cutting spending or raising taxes, Bonn made a third mistake.

- Bonn over-borrowed to finance these soaring unity costs. In an over-zealous war against inflationary pressures, the Bundesbank counter-punched and raised interest rates, which in turn hammered the Italian and UK economies. What was missing in Germany was economic and financial leadership.

Fed's Monetary Overkill. We've also seen where over-zealous U.S. policy initiatives damaged the Mexican and Asian economies in the 1990s. For instance, the U.S. Federal Reserve raised interest rates seven times in a nine month period in 1994. While these actions did not cause the peso crisis in Mexico, the Fed's actions certainly worsened Mexico's financial problems. Had the Fed given more consideration to Mexico's dilemma, the peso crisis would arguably have still happened. But perhaps the huge bail-out of Mexico might have been smaller and the subsequent Mexican recession less severe had Washington possessed more situational awareness of Mexico's financial mess.

Overly Strong Dollar Policy. Similarly, Washington orchestrated a strong dollar policy with the other G3 countries that was probably short-sighted, with little or no consideration given to how this action would damage the developing Asian economies. Again, the Asian economic crisis would arguably have still happened. But perhaps the huge bail-outs of Thailand, Indonesia and South Korea might have been smaller and their subsequent recession less severe if Washington had possessed more situational awareness of the Asian financial mess.

China's Devaluation. Finally, China's decision to devalue was also shortsighted and worsened the financial turmoil in the rest of developing Asia.

Not Helpless Victims. That said, we've seen that crisis-hit economies were in no way helpless victims of an unjust international financial system; nor is financial breakdown "a nomadic creature" with the power to settle into any address of its own choosing. On the contrary, the financial crises never arrived without having first received a "hand-delivered invitation" from domestic policymakers. The financial problems of the 1990s were not caused by any malfunction in the international financial system. Financial disaster was initially and primarily homegrown. In this sense, the free market too often gets a "bum rap" from the advocates of financial reform. In short, crisis-hit economies "largely shot themselves in the foot."

ERM Too Rigid. While ERM is not a pure fixed exchange rate regime, we learned that this so-called convergence half-way house is unstable. It was far too rigid to accommodate the conflicting pressure from a European recession that demanded low interest rates and a botched German economic and monetary unification that demanded high interest rates. We also saw the folly of the UK entry into ERM at a heavily overvalued exchange rate.

Overvalued Pound. In addition, we learned the futility of the UK trying to defend their

overvalued and exchange rates by exhausting billions of dollars of currency reserves. The UK attempt to raise interest rates to defend these absurd exchange rates was equally futile. George Soros and other currency traders realized that the UK simply could not sustain high interest rates in the face of politically unacceptable rising unemployment. The market is simply too powerful for governments to pursue ill-advised policies. It would have been far more sensible for the UK to float the pound before the crisis or at least in the early moments of the crisis. It was no coincidence that the UK economy did much better once it left the ERM and the Bank of England finally had the freedom to ease monetary policy without hysteria.

Common Denominators: Moreover, we learned that the common denominator in practically every financial crisis in the emerging market economies in the 1990s were:

- Fixed (or nearly fixed) exchange rate regimes and persistent and
- Large current account deficits.

Trade Imbalance. Mexico and Thailand were both running huge current account deficits of 8% of GDP. Their governments were not worried. Their central bank claimed they were "loaded" with foreign reserves to hold off an attack on their fixed exchange rates. Yet when the crisis struck, the size of their reserves proved woefully inadequate, something that could have been deduced from what had happened to the much larger European central banks in the ERM crises of 1992 and 1993. Making this situation worse was the Thai corporate practice of borrowing on a short-term basis.

Deadly Combination. We've also seen the implausibility of an emerging market nation's running a sustained, large current account deficit while trying to maintain a fixed exchange rate regime. The capital that flows in from abroad, which sustains the current account deficit, can stop or even reverse direction in an instant if there is even a whisper that devaluation is being considered. The most crisis-prone environment of all combines a fixed exchange rate system, a history of current account deficits and an investment environment where confidence is rapidly decaying. That in fact was the combination of factors, the perfect witch's brew, that brought down Mexico and most of Southeast Asia.

False Indicator. In addition, the Mexican government argued that that the $91B in capital inflow was more than enough to offset its financial liabilities. The government also argued that this capital inflow was a "vote of confidence" in the Mexican economy. We've learned that nothing could be further from the truth. The capital inflow in Mexico and Thailand resulted from a Thai baht and a Mexican peso that were drastically overvalued and required a huge interest rate differential from the U.S. dollar to fend off devaluation. These fixed exchange rate regimes incubated the buildup of massive foreign exchange via carry trades and huge foreign debt markets. Both were motivated by the illusion that fixed exchange rate regimes were permanent. While these regimes all promised currency stability, the day of reckoning for these financial pressure cookers ultimately arrived with a devastating explosion.

Conclusions

Based on these lessons learned, we can make a number of recommendations:

- Develop a global consensus that supports free international capital markets.
- In this regard, keep international capital markets free from moral hazard. Keep the connection between choices and outcomes. In short, don't eliminate risk assessment in investment decisions.
- Encourage almost all countries to choose a floating exchange rate regime. Floating exchange rate regimes will reduce the strain on foreign exchange reserves and the need for large IMF bail-outs.
- Discourage fixed exchange rate regimes for all but tiny economies. [9]
- Discourage most countries from running high current account deficits.
- Persuade large economies to give more consideration to what goes on outside their borders when they make critical

macroeconomic and international economic decisions.

- Strengthen IMF capacity for better and earlier situational awareness of financial turmoil.
- Persuade large economies to adopt more insightful macroeconomic policies that would also reduce the need and the size of bailouts.
- In short, an ounce of prevention is worth more than a pound of a cure.
- If countries insist on maintaining fixed exchange rates, then we need to prepare for the worst and hopefully avert it with good crisis management in the early stages of financial deterioration.

A Financial Early Warning System. In this regard, it's not enough to look back and determine what went wrong. It's also important to know what to watch for in the future to avoid other financial train wrecks. We need to closely monitor economies at risk and vulnerable to financial turmoil. Instead of passively waiting for the next financial crisis to occur and then suddenly reacting to it, we need to be more pro-active to early indications and warning (I&W) of financial turmoil. In other words, we need to make sure policymakers are not "caught off guard" by sudden financial turmoil. But how do we know which countries are at risk?

We need to develop an early warning system for national financial chaos. This financial indications and warning (I & W) system would sound alarm bells when a state's economic performance is in the danger zone. Some of the I & W alarm bells fall into the following five broad financial categories: an overvalued currency (fixed exchange rate system), inability or no political resolve to defend currency, the nature of high current account deficit (sustainability), the nature of capital inflow and the nature of the debt. In addressing each category, we have a number of specific factors we would watch. For instance, in analyzing whether a currency is overvalued, we will watch three indicators: inflation differentials (which carry traders exploit), an export slowdown and a current account deficit as a percent of GDP. In assessing a current account deficit, we might use the following "ball park" signals. If a country has a current account deficit of say 3% of GDP, that's in the safety zone (green light). If a country has a current account deficit of 5% of GDP, that's a reason for concern (yellow light). If a country has a current account deficit of 8% of GDP (where both Mexico and Thailand were before their meltdowns), that's cause for alarm or a red light.

In addressing whether or not a country can defend its currency, we need to look at both the actual foreign reserve level as well as the more subjective call of whether the country has the political resolve to defend the exchange rate. A good example here would be China. China certainly has robust foreign reserves. But does China have the political resolve to defend its currency with such high levels of unemployment and social unrest? In this case, it's absolutely essential for the economists to check with political analysts before making the call. We also need to look at monetary policy constraints. For instance: Will an upcoming election kill the political will to raise interest rates to defend the currency? Will weak banks and/or a property bubble make it impossible to raise interest rates to defend the currency? For instance, the government might be fearful that the whole banking system would collapse under such a credit crunch.

We also need to look beyond the actual current account as a percentage of GDP. In asking whether or not a high current account deficit as a percentage of GDP is sustainable, we need to ask: Are the imports going mostly for investment (good) or for consumption (bad)? If the imports are mostly going for investment, then we need to ask: Is this investment going for tradable goods (exports)—which is good; or for non-tradable goods (e.g. over-saturated property market)—which is bad? If robust capital inflows (in the capital account of the balance of payments) are offsetting a high current deficit, we need to ask whether the capital flows are primarily stable (such as foreign direct investment)—which is good; or primarily unstable (stocks or hot money)—which is bad?

Finally, in assessing private foreign debt, we need to look at the following: How much debt is stable and of long-term maturity and how much is less stable and of short-term maturity? And what percentage of the debt is hedged (protected) in the futures market—which is good—and what is unhedged (vulnerable to currency devaluation)—which is bad? In short, U.S. and foreign government organizations need to share research and work closely with other international financial agencies to develop and take advantage of an early warning system that would give U.S. and foreign government officials a strategic warning of global financial turmoil.

Endnotes

1 World Bank, *The East Asian Miracle*, 1993.

2 I agree with the Wall Street traders who perceived the Asian currencies were overvalued. That's why they attacked them. On the other hand, some analysts take a more technical view and disagree with me and Wall Street traders that the Asian currencies were overvalued. For instance, Morris Goldstein argues that on most technical yardsticks such as estimates of purchasing-power parities (PPPS, which equate the prices of a basket of goods and services in different countries), most Asian currencies were actually undervalued.

3 The Philippines was the exception. After years being "lost in the wilderness" fighting the New People's Army (NPA), the Philippines finally got its economic house in order and emerged as a competitive low wage producer of low tech goods. It actually ran healthy surplus in its current account due to strong exports as well as capital inflows from overseas Filipinos. Its currency fell more because of regional contagion than because of flaws in its national economic strategy.

4 Ill-advised investment spending on unnecessary capacity is especially dangerous if it is coupled with rapid monetary growth, which tends to inflate an asset-price bubble. Of course, when the bubble ultimately burst, it left Thai banks with huge bad loans on their books. Like Mexico in 1994, Thailand had way too much money sloshing around in 1996 and 1997.

5 The Thai central bank pegged the baht to a basket of currencies in which an estimated 84% of its value was accounted for by U.S. dollars.

6 The trade frequently consisted of a long position in the Thai baht that was hedged with forward contracts in the basket currencies. When the baht floated, it plunged, and investors took the full hit for the devaluation and were left owing debts in hard currency.

7 DeRosa, David F., *In Defense of Free Capital Markets, 2001*.

8 By the end of June 1997, about 12% of bank loans and 20% of finance company loans were non-performing, worth in total about Bt1 trillion or 20 percent of GDP. By the end of May finance companies had liabilities of Bt 1.39 trillion, outstanding foreign loans worth Bt 111B and outstanding promissory notes worth Bt 912 B.

9 For those tiny economies that argue that floating exchange rates are "too volatile", remind them that the trendy currency boards or dollarization equate to sacrificing their monetary policies to say the U.S. Federal Reserve. That means if the economic problem is recession in the small economy and the economic problem in the United States is inflation, understand that the Fed may well inadvertently worsen unemployment in this small economy via higher interest rates.